Give to Charity, Turn a Profit

by David Cay Johnston

David Cay Johnston received the Pulitzer Prize for his coverage of tax policy while at The New York Times. He now teaches at Syracuse University College of Law and is the author of three books about taxes: Free Lunch, Perfectly Legal, and The Fine Print.

In this column, Johnston writes that Arizona lawmakers let some donors make charitable gifts in a way that makes the donors richer, a trend sure to spread unless Congress stops it.

Arizona taxpayers who itemize deductions on their federal returns can turn a profit by giving to charity, thanks to a system of state tax credits.

Instead of a tax savings that merely reduces the cost of charitable giving, in Arizona, five individual tax credits can be cumulatively applied to make a tidy profit from the federal government. The biggest profits can come from giving to religious schools, raising questions about both the separation of church and state and the First Amendment.

Charitable donations of just under $3,300 by a married couple in the top tax bracket can yield a profit of almost $1,300. That is a nearly 40 percent return. Best of all for the donor, that return is risk free and guaranteed, so long as one complies with the rules, which the Legislature has gradually turned from maddeningly complex into really simple.

Any system that converts charitable gifts from subsidized sacrifice into profit-making deals is sure to grow and spread. Indeed, over the last four years, Arizona lawmakers significantly expanded the profits that can be had by making charitable gifts. They also made it easier to get the tax credits. Patrick McWhorter of the Alliance of Arizona Nonprofits said he kept donating but quit trying to collect one of the tax credits a few years ago because of onerous rules. But a state law that took effect in 2012 relaxed those rules, so McWhorter said he has resumed taking the credit.

Arizona charities and schools are busy promoting the tax credits on their websites, in mass mailings, and in one-on-one meetings with potential donors. It is a pitch sure to make some people whip out their checkbooks: “Donate at zero cost and then make a profit of up to 40 cents on the donated dollar.”

Only about one-third of Arizona taxpayers qualify to turn a profit on their charitable gifts — they itemize, and tend to be higher-income earners. Even taxpayers in the 10 percent federal income tax bracket can make a few dollars, provided they itemize, but most itemizers are in the higher tax brackets.

Effective in 2012, the Legislature revised state law to allow any resident owing Arizona income taxes to make charitable gifts at no cost. That expansion benefited the roughly two-thirds of state residents who take the standard deduction and file short-form tax returns.

Kathleen Murphy runs Big Brothers Big Sisters in Yavapai County, north of Phoenix, where wealthy retirees are surrounded by low-income families. Murphy said the dollar-for-dollar tax credit helps raise money only from families that both pay state income taxes (so they can take advantage of the nonrefundable credits) and have sufficient income to afford to make gifts.

The tax credit system exacerbates the large divide between high- and low-income Arizonans. A December 18, 2013, headline in The Arizona Republic, Phoenix’s daily newspaper, captured the effect of a state tax credit for gifts to public schools: “Tax Credits Are Making Rich Schools Richer.”

There is no free lunch, so others must make up the cost of a tax credit that benefits only a few. With the new rules, and a push by charities for tax-credit-motivated gifts, the total amount being forgiven is likely to grow substantially in the next few years, cutting into the Arizona fisc. The tax revenue that state and federal governments lose must be financed. That financing can be through higher taxes, reduced services, or a combination of the two, plus, for the federal government, more borrowing than would otherwise occur.

How It Works

Here is how Arizona’s charitable tax credit deals works: There are five charitable credits on which donors can make a profit, each with different profit prospects. None are refundable, so a taxpayer who owes less in state income tax than the value of the donation gets only a partial credit from the state. However, the charitable credits can be carried forward for up to five years.

Qualifying taxpayers can take up to all five charitable tax credits, each of which reduces their state income tax liability dollar-for-dollar. That means those gifts cost the donor nothing. If the taxpayer itemizes, he receives a federal income tax deduction for the full amount donated. That federal deduction reduces his federal income tax by the amount he would have paid on the money had it not been donated.
Consider an Arizona resident paying the top federal tax rate of 39.6 percent who makes a $100 gift that qualifies for one of the Arizona tax credits. The gift is entirely offset by the $100 state tax credit. The taxpayer then gets a federal income tax deduction that saves her $39.60 in federal income taxes.

The taxpayer has just turned a profit of 39.6 percent on a $100 expense at no risk. In any era, a 39.6 percent return is phenomenal. In this era of near-zero interest rates, an immediate, risk-free, and guaranteed 39.6 percent profit is on par with a golfer hitting several consecutive holes-in-one year after year.

Qualifying taxpayers can take up to all five charitable tax credits, each of which reduces their state income tax liability dollar-for-dollar. That means those gifts cost the donor nothing.

Because charitable gifts are often made on the last day of the year, the tax savings are immediate. Marketed that way (“Give $100 today and make $39.60 immediately”), plenty of people without a charitable thought are sure to donate.

Compare that money-making opportunity with what happened in Arizona before the first of the charitable tax credits took effect in 1998. Back then, assuming the taxpayer itemized, she got both a federal and a state tax deduction. If the net combined federal and state tax rate was 44 percent, then the net cost of a $100 charitable gift was $56. That is a good deal, but it still required the taxpayer to give up $56 after tax. Today the taxpayer can make an instant $39.60 profit off a donation of $100.

**Table 1.**

<table>
<thead>
<tr>
<th>Year</th>
<th>School Tuition Charities</th>
<th>Individual Donors</th>
<th>Donations</th>
<th>Average Donation</th>
<th>Scholarships Granted</th>
<th>Total Scholarship Amount</th>
<th>Average Scholarship</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>16</td>
<td>4,248</td>
<td>$2,557,642</td>
<td>$602</td>
<td>128</td>
<td>$146,193</td>
<td>$1,142</td>
</tr>
<tr>
<td>1999</td>
<td>33</td>
<td>32,023</td>
<td>$18,992,342</td>
<td>$593</td>
<td>3,207</td>
<td>$3,027,363</td>
<td>$944</td>
</tr>
<tr>
<td>2000</td>
<td>36</td>
<td>38,249</td>
<td>$23,601,122</td>
<td>$617</td>
<td>15,081</td>
<td>$18,082,189</td>
<td>$1,199</td>
</tr>
<tr>
<td>2001</td>
<td>43</td>
<td>46,696</td>
<td>$32,277,295</td>
<td>$691</td>
<td>18,049</td>
<td>$21,371,264</td>
<td>$1,184</td>
</tr>
<tr>
<td>2002</td>
<td>43</td>
<td>52,203</td>
<td>$33,597,667</td>
<td>$644</td>
<td>19,582</td>
<td>$28,926,737</td>
<td>$1,477</td>
</tr>
<tr>
<td>2003</td>
<td>51</td>
<td>58,122</td>
<td>$36,741,920</td>
<td>$632</td>
<td>20,134</td>
<td>$30,471,103</td>
<td>$1,513</td>
</tr>
<tr>
<td>2004</td>
<td>53</td>
<td>63,830</td>
<td>$38,707,184</td>
<td>$606</td>
<td>21,146</td>
<td>$34,062,527</td>
<td>$1,611</td>
</tr>
<tr>
<td>2005</td>
<td>53</td>
<td>69,239</td>
<td>$49,605,860</td>
<td>$716</td>
<td>22,529</td>
<td>$36,282,723</td>
<td>$1,610</td>
</tr>
<tr>
<td>2006</td>
<td>56</td>
<td>73,617</td>
<td>$70,835,716</td>
<td>$962</td>
<td>24,678</td>
<td>$56,370,186</td>
<td>$2,284</td>
</tr>
<tr>
<td>2007</td>
<td>55</td>
<td>76,065</td>
<td>$60,132,977</td>
<td>$791</td>
<td>27,153</td>
<td>$53,773,327</td>
<td>$1,980</td>
</tr>
<tr>
<td>2008</td>
<td>55</td>
<td>78,434</td>
<td>$58,928,935</td>
<td>$751</td>
<td>28,527</td>
<td>$57,803,548</td>
<td>$2,041</td>
</tr>
<tr>
<td>2009</td>
<td>54</td>
<td>73,430</td>
<td>$54,449,852</td>
<td>$742</td>
<td>27,592</td>
<td>$55,785,553</td>
<td>$2,022</td>
</tr>
<tr>
<td>2010</td>
<td>53</td>
<td>62,940</td>
<td>$45,468,375</td>
<td>$722</td>
<td>26,433</td>
<td>$49,849,437</td>
<td>$1,886</td>
</tr>
<tr>
<td>2011</td>
<td>49</td>
<td>71,614</td>
<td>$49,994,831</td>
<td>$698</td>
<td>10,891</td>
<td>$29,133,088</td>
<td>$2,675</td>
</tr>
<tr>
<td>2012 — 1st 6 months</td>
<td>47</td>
<td>23,608</td>
<td>$15,592,213</td>
<td>$660</td>
<td>23,899</td>
<td>$45,525,163</td>
<td>$1,905</td>
</tr>
<tr>
<td>Change 1998-2011</td>
<td>33</td>
<td>67,366</td>
<td>$47,437,189</td>
<td>$96</td>
<td>10,763</td>
<td>$28,986,895</td>
<td>$1,533</td>
</tr>
<tr>
<td>Percent</td>
<td>206 percent</td>
<td>1,586 percent</td>
<td>1,855 percent</td>
<td>16 percent</td>
<td>8,409 percent</td>
<td>19,828 percent</td>
<td>236 percent</td>
</tr>
</tbody>
</table>

Sources: Arizona DOR; inflation adjustments by author.

There is, of course, a rub. Actually, there are at least two: one that would trouble economists and one that asks whether some of the tax credits violate the U.S. and Arizona constitutions.

First, the dollar-for-dollar credits are a form of government interference that distorts markets — in this case, the market for charitable gifts. Given the libertarian traditions in Arizona, the tax credits seem at first blush a curious economic and political development. But viewed through the lenses of antagonism to government and of making affluent voters better off, the tax credit policy makes political sense.

Arizona lawmakers apparently love to interfere in market decisions by handing out tax credits, an anomaly in a state where officials have long promoted libertarian ideas. In November 2013 the Arizona Department of Revenue detailed 44 individual income tax credits enacted over the last...
15 years.¹ In 2012 Arizona’s 6.5 million residents received $214.5 million in state tax credits, of a maximum of $252.9 million they could have received. In a state with 2.6 million taxpayers according to the DOR, almost 1.6 million tax credits were approved. A minority of taxpayers collected multiple credits, while most got one or none, according to state reports.

Some of those credits are for bread-and-butter items, such as to offset income taxes paid to other states or foreign governments, which benefit about 1 percent of Arizona taxpayers. That credit in 2012 saved 32,281 taxpayers $93.4 million, an average of almost $2,900 each, according to DOR data.

Some credits, such as the research and development credit, have a few hundred claimants. Many credits, such as those for solar projects, for donating school sites, and for “clean elections,” are dormant, or used by fewer than 10 taxpayers. Some are used by only one or two companies, which we know because the report, which shows when three or more taxpayers take a credit, says data for those credits can’t be released.

A second problem is that the dollar-for-dollar tax credits are available only to those charities approved by the Arizona Legislature, including religious schools. Other charities qualify only for a state income tax deduction, worth no more than 4.1 cents on the donated dollar.

One credit lets taxpayers donate to public schools but only to finance extracurricular activities and character education programs. It is capped at $400 for a couple ($200 for a single taxpayer), limiting the maximum profit for federal itemizers to $158. In 2012 the state report shows that 253,162 taxpayers donated $51.8 million for those purposes, with a quarter of that money financing sports.² Most of the money went to a minority of school districts, all among the most affluent, with many poorer districts getting almost nothing.

A more generous credit is given for donations to private schools, including religious ones. In 2012 it was capped at $1,000 for a couple and $500 for singles and heads of household. However, the credit is indexed to inflation and in 2013 increased to $1,034 for a couple and $517 for others. The Legislature then approved an additional credit for 2013 of $1,028 for couples and $514 for singles and heads of household.

---


²Id.
There is a credit for gifts to charities that spend at least half their budget on the working poor, defined as those making less than 150 percent of the official poverty level. It is capped at $400 for a couple ($200 for singles and heads of household). And approximately 3,000 taxpayers each year claim about $1 million in credits for relief for military families.

So the working poor and public schools can get $400 each from married taxpayers, while private schools can get more than five times as much, with a dollar-for-dollar state tax credit.

It takes about $100,000 of income to qualify for all five credits. A married couple meeting that threshold can give $1,200 to public schools, the working poor, and military relief, plus $2,062 to private schools at no cost if their state tax liability is that high. If they’re in the top tax bracket, the couple can turn a profit of $1,292 if they itemize on their federal income tax return.

Tom Cantlon, a columnist for the Prescott Daily Courier, said nonprofits that help low-income individuals have a tough time competing with private and parochial schools for donations. “I already gave to the school” is one of the most common explanations for why requests for funds for those nonprofits are turned down, Cantlon said.

The most suspect aspect of the Arizona scheme is that it heavily favors private schools, most of which are religious.

Many people wrongly believe that if they get a refund as a result of overpaying their state income tax, they are ineligible for the tax credits, Cantlon said, adding that he believes changing that thinking will be “a time-consuming, one-by-one process of education.”

The most suspect part of the Arizona scheme is that it heavily favors private schools, most of which are religious, by giving not just the largest credit, but two separate credits. Catholic schools are by far the largest single beneficiary of the private school tax credits.

The First Amendment to the U.S. Constitution provides that “Congress shall make no law respecting the establishment of religion.” Article II, section 12 of the Arizona Constitution bans public funding “to the support of any religious establishment,” and Article IX, section 10 bans taxes or appropriations “made in aid of any church, or private or sectarian school, or any public service corporation.”

The Arizona Supreme Court held in 1999 that the plaintiffs in Kotterman v. Killian failed to demonstrate that the tax credits for donating to private schools, of which more than 70 percent were religious, violate the U.S. or state constitutions, a decision some legal scholars called revolutionary and unprecedented. The court said that under the state constitution, a tax credit is not an appropriation of taxpayer funds. It belittled the idea that the credit is tilted toward official support of religion because it is larger than the credit available for gifts to public schools.

The court said the “tuition tax credit is a neutral adjustment mechanism for equalizing tax burdens and encouraging educational expenditures.” It characterized opposition to the tax credit for parochial schools as anti-religious bigotry and described aid to religious schools as incidental to school funding.

The court placed great weight on the fact that the Legislature did not appropriate taxpayer funds to religious schools but rather let donors to those schools avoid a levy through the tax credit. But a dollar forgiven through a tax credit is identical to a dollar appropriated, making the court’s reasoning preposterous.

Two Arizona Supreme Court justices dissented. Stanley G. Feldman called the holding a “badly disguised end-run around the state constitution” and “as invalid as a statute limiting charitable deductions only to contributions to religious organizations.” Having a smaller credit for public schools than for religious ones was evidence of government helping establish religion, he added.

The court’s approval of the credits is surprising in light of concerns the U.S. Congress had about separating church and state in Arizona, where the Mormon Church holds significant sway. While the tax credit does not prohibit religious practice, it clearly subsidizes religion. Indeed, it can turn giving to religious schools into a profitable experience.

The Arizona Supreme Court held in 1999 that the plaintiffs in Kotterman v. Killian failed to demonstrate that the tax credits for donating to private schools, of which more than 70 percent were religious, violate the U.S. or state constitutions, a decision some legal scholars called revolutionary and unprecedented. The court said that under the state constitution, a tax credit is not an appropriation of taxpayer funds. It belittled the idea that the credit is tilted toward official support of religion because it is larger than the credit available for gifts to public schools.

The court said the “tuition tax credit is a neutral adjustment mechanism for equalizing tax burdens and encouraging educational expenditures.” It characterized opposition to the tax credit for parochial schools as anti-religious bigotry and described aid to religious schools as incidental to school funding.

The court placed great weight on the fact that the Legislature did not appropriate taxpayer funds to religious schools but rather let donors to those schools avoid a levy through the tax credit. But a dollar forgiven through a tax credit is identical to a dollar appropriated, making the court’s reasoning preposterous.

Two Arizona Supreme Court justices dissented. Stanley G. Feldman called the holding a “badly disguised end-run around the state constitution” and “as invalid as a statute limiting charitable deductions only to contributions to religious organizations.” Having a smaller credit for public schools than for religious ones was evidence of government helping establish religion, he added.

The court’s approval of the credits is surprising in light of concerns the U.S. Congress had about separating church and state in Arizona, where the Mormon Church holds significant sway. While the tax credit does not prohibit religious practice, it clearly subsidizes religion. Indeed, it can turn giving to religious schools into a profitable experience.

---